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MEMORANDUM

November 19, 2010

TO: Interested Persons

FROM: Ron Kirk, Economist, 303-866-4785

SUBJECT: Federal Estate and Wealth Transfer Taxes

This memorandum provides information on the federal estate and wealth transfer taxes. Colorado no longer has an estate tax. Colorado's estate tax was levied on decendents whose deaths occurred through 2004.

Summary

The federal wealth transfer tax system is composed of three taxes — the federal estate, generation-skipping transfer, and gift taxes. The federal estate tax is imposed upon a person's assets held at death. The generation-skipping transfer (GST) tax applies to wealth transfers that go directly to people who are two or more generations younger than the transferor. The federal gift tax is an excise tax on the privilege of making a gift during a person's lifetime that can be paid in addition to the federal estate tax.

In the 2009 tax year, the federal estate tax was levied on the transfer of estates valued at over $3.5 million. The top-tier federal estate tax rate for 2009 was 45 percent. The federal estate tax is scheduled to be repealed in 2010. Thus, persons dying in 2010 will owe no estate tax. Under current law, the estate tax will revert to 2001 law in 2011. If someone dies in 2011, the decedent's estate will be subject to a $1 million exemption rather than the $3.5 million exemption that was in place for 2009. The President's proposed 2010 budget would make the $3.5 million exemption amount and tax rates permanent and retain certain tax advantages that are applied to inherited assets. At the time of this research, Congress has not yet taken action on this issue.

Federal Estate and Wealth Transfer Taxes

The federal wealth transfer tax system is composed of three taxes — the federal estate, generation-skipping transfer, and gift taxes. The federal estate tax is imposed upon a person's assets held at death. The generation-skipping transfer (GST) tax applies to wealth transfers that go directly to people who are two or more generations younger than the transferor. The federal gift tax is an excise tax on the privilege of making a gift during a person's lifetime that can be paid in addition to the federal estate tax. Table 1 summarizes exemption levels and tax rates for each of the federal wealth transfer taxes.

How does the estate tax work? When someone dies, an estate tax is imposed on all of the decedent's property that was owned at death.[1] Some expenses, such as certain bequests to spouses, charitable contributions, funeral expenses, the deceased's outstanding debts, and other expenses related to the transference of ownership may lower a taxpayer's liability. For 2009, estates valued at more than $3.5 million must file an estate tax return. The taxable portion of the estate above $3.5 million is subject to a graduated tax rate that ranges from 18 percent on the first $10,000 to a maximum tax rate of 45 percent. The maximum rate is applied to the amount of taxable estate value in excess of $1.5 million. For example, an estate with a taxable value of $5.0 million or greater is subject to this rate.

Under current federal law, persons dying in 2010 will owe no estate tax.[2] If someone dies in 2011, the decedent's estate will be subject to a $1 million exemption rather than the $3.5 million exemption. Thus, estates having a taxable base greater than $1 million would be paying federal estate taxes on the value of the estate in excess of $1 million. In addition, the maximum estate tax rate will return to 55 percent. Information from the Congressional Research Service on the graduated tax rate schedule for these years is included as Attachment A *(see appendix)*.

The President's proposed 2010 budget would make the current $3.5 million exemption amount and tax rates permanent and retain certain tax advantages that are applied to inherited assets. At the time of this research, Congress has not yet taken action on this issue.

How are generation-skipping transfers taxed? Prior to 1976, wealthier families were able to bypass the federal estate tax by transferring wealth beyond one generation to either a grandchild or great-grandchild. For example, wealth from a donor would be transferred down the family chain through a well-crafted trust two or more generations such that the right to income would flow directly from the donor to grand or great-grand-children. Thus, the donor would avoid paying federal estate taxes for each generational skip.

Congress enacted the generation-skipping transfer tax (GST) in 1976. The GST tax applies to wealth-transfers that go directly to people who are two or more generations younger than the transferor. Thus, the GST taxes wealth-transfers that would have otherwise not been subject to

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1 IRC Sec. 2001.

2 The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) made a number of significant changes to wealth transfer taxes. The law repeals the estate (and generation-skipping transfer) tax in 2010. If Congress does not take action, the federal estate tax will be restored to 2001 levels on January 1, 2011.

taxation prior to 1976.[3] Like the estate tax, the exemption for the GST was set at $3.5 million in 2009. Thus, estates with a taxable base above $3.5 million and transferred beyond one generation are treated the same as a first-generational transfer for federal estate tax purposes. Like the federal estate tax, GST taxes are subject to a maximum tax rate of 45 percent. The GST is repealed in 2010, and reverts to the same tax treatment as the federal estate tax in 2011.

How does the gift tax work? The federal gift tax is an excise tax levied on annual transfers of wealth during a donor's lifetime. It is imposed on the transfer of property by gift from an individual, resident, or nonresident. The *person who gives the gift* (called the donor) is responsible for paying the gift tax. There are many transfers of property that may be excluded from gift taxes during the donor's lifetime. As an example, charitable and marital deductions, certain transfers to benefit a minor, or medical expenses are not subject to the federal gift tax.

For 2010, the tax is imposed on the transfer of property or wealth in excess of $13,000 and gifts over this amount must be reported as taxable gifts on the donor's tax return.[4] There is no limit on the number of donees that a donor may give to nor the number of years in which gifts may be subject to the annual $13,000 exclusion. The $13,000 exclusion is a "use it or lose it" adjustment which, although available annually, cannot be carried forward to subsequent years. Under a family trust, both husband and wife can each give gifts up to an exclusion amount total of $26,000 before the gift tax is imposed.

Gifts given by a donor that exceed $13,000 ($26,000 for husband and wife) require the donor to file a federal gift tax return because gifts over the annual threshold become "taxable gifts." However, the donor may not owe a gift tax if, over the donor's lifetime of annual gifts, total taxable gifts do not exceed $345,800. For 2009, the $345,800 amount is a unified credit that results from a $1.0 million exemption level in place for 2009 and 2010. In 2009, for total lifetime gifts that exceed $345,800, the gift tax rate ranges from 18 percent on the first $10,000 of taxable gifts to 45 percent for taxable gifts that exceed $1.5 million. The maximum 45 percent rate is reduced to 35 percent in 2011.

Table 1
Federal Wealth Transfer Taxes

Year	2009	2010	2011
Estate and Generation Skipping Transfer tax			
Exemption	$3.5 M	Unlimited	$1.0 M
Maximum Tax Rate	45 %	None	55 % with 5 % surcharge on estates between $10.0 M and $17.2 M
Gift Tax			
Exemption	$13,000 (annual exclusion) ; $1.0 M (lifetime)		
Maximum Tax Rate	45 %	35 %	55 % with 5 % surcharge on estates between $10.0 M and $17.2 M

Source: CCH, 2010 Estate & Gift Tax Handbook.

3 IRC Sec. 2601.

4 IRC Sec. 2501.

Cost of gift and estate transfers. Aside from the purpose of giving monetary or other gifts to family or others, the gift tax may be used to lower an estate's tax liability. Thus, the federal estate taxes owed upon death can be reduced. A lifetime program of making gifts can also make sense for a number of other reasons. One reason is that a gift costs less than a transfer of wealth at death. The following example illustrates this principle.

A taxpayer is in the 50 percent gift and estate tax bracket. The taxpayer gives $50,000 to her child and pays a gift tax of $25,000 plus the $50,000 gift. This means that during the taxpayer's lifetime, the gift cost $75,000. If the same transfer is made at death, the cost would be $100,000 because $100,000 of estate wealth would have to be transfered to result in a $50,000 gift for a person in a 50 percent bracket ($50,000 estate tax plus the gift of $50,000). Table 2 illustrates this scenario.

Table 2
Gift and Estate Transfers

Gift Tax Transfer		Estate Tax Transfer	
Gift (lifetime transfer)	$50,000	Estate ($100,000 transfer after death)	$50,000
Tax (50 % bracket)	25,000	Tax (50%)	50,000
Total cost of gift	$75,000	Total cost of transfer	$100,000